Reducing Corporate Tax Loopholes

1. What is being proposed?

- The Governor wants to <u>reduce</u> two corporate tax loopholes: the FOC deduction and the foreign royalty subtraction.
- Under those provisions, 80% of the income that a corporation derives from its operations or subsidiaries based (or mostly operating) overseas is not taxed by Minnesota.
- The Governor would reduce those preferences by 22% from current level in 2012 (when 62% of this income would be untaxed), and by 51% from current level in 2013 and beyond (when 39% of this income would be untaxed).

2. What is a foreign operating corporation (FOC)/foreign corporation?

- FOC is based in the U.S. and derives at least 80% of its income from foreign business activities (such as overseas manufacturing). Its profits are treated as dividends paid to the parent company (which can deduct a portion on its Minnesota tax return)
- A foreign corporation is incorporated overseas.
- FOCs and foreign corporations pay royalties to the parent company (which can subtract a portion from taxable income on its Minnesota tax return).

3. When and why were these provisions enacted?

- In 1984 and 1988, state tax laws were changed to lower the Minnesota tax on the income U.S. corporations received from their overseas operations.
- These changes were meant to put U.S. corporations on the same footing as foreign-based competitors that sell goods or services into Minnesota but have little payroll or property here.
- Our corporate income ("franchise") tax was based on the Minnesota portion of a corporation's total sales, property and payroll (the "apportionment formula"). This formula tended to favor foreign-based corporations, since they had little or no payroll or property in Minnesota.

4. Why we should reduce them?

- There are more efficient ways to grow jobs and economic activity here, such as the R&D credit and Jobs NOW tax credit.
  - These preferences can be used by any corporation that pays taxes in Minnesota.
  - But only corporations that do R&D or create jobs in Minnesota can take the R&D credit and the Jobs NOW credit.
- The laws need to be updated to reflect current business practices and current MN tax code.
  - Minnesota is gradually removing property and payroll from its "apportionment formula." Effective 2014, MN's corporate income tax will be based solely on sales in the state.
  - Minnesota's R&D credit has increased in recent years, which encourages businesses to place R&D activities in the state (the only way they can get the credit).
- These preferences are used by relatively few taxpayers – less than 1% of the 35,000 corporations the file unitary tax returns in Minnesota.
  - 170 of them claim FOC deduction, and 108 of them account for 98% of the preference
  - 750 of them claim foreign royalty subtraction, and 147 of them account for 95%

5. How many other states have these items?

- Very few, and none have the same preferences as Minnesota.
- 10 states have similar deductions for foreign source income; 4 states have similar foreign royalty subtractions

6. What is the effect on our corporate tax rate by retaining them?

- On average, a taxpayer who claims the FOC deduction will pay $82,000 more annually. On average, a taxpayer who claims the foreign royalty subtraction will pay $70,000 more annually.
- Based on Department figures from 2011, these corporate preferences reduce tax revenues annually by about 10%.
- Approximately $30M in tax revenue is forgone annually as a result of the FOC deemed dividends deduction.
- Approximately $80M in tax revenue is forgone annually as a result of the foreign royalty subtraction.